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Competent Institutions and Selective Globalisation

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A key message from Charles Wyplosz' insightful chapter is that developing countries are different from developed countries in financial matters. While the developed countries may be rocked by serious financial disturbances, their financial markets remain resilient and their governments and central banks have many tools available to cushion any blow. In contrast, in the developing countries, minor disturbances can have massive effects. Charles Wyplosz reviews the causes of emerging market's financial instability: i.e. policy mistakes, public indebtedness, market volatility and original sin. I would like to express a few thoughts about his explanations.

First, misguided macroeconomic policies are often likely to generate financial instability. For instance, unsustainable fiscal policies lead to the accumulation of public and external debts, or high inflation is inconsistent with a fixed exchange rate. If so, why do many emerging market governments make such policy mistakes? The answer may be that the ability of governments to make wise economic decisions is constrained by the quality of the political and social institutions, and that these institutions are shaped by history. Political pressures for maintaining high rates of economic growth may lead to inflationary monetary policy and undisciplined fiscal spending. Many developing countries fail to build a democratic governance system in making economic policy decisions. However, in the case of Japan, misguided macroeconomic policies were responsible for a decade of economic stagnation during the 1990s. Also, even under the authoritarian regime, East Asia's economic rise could be attributed, in large part, to responsible and disciplined fiscal and monetary policies.

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Second, as pointed out by Charles Wyplosz, governments with weak quality may be tempted to accumulate a large debt and then expropriate its creditors, whether they are domestic or foreign. This notion implies that creditors and investors should evaluate risks more carefully as they seek higher yields. In other words, international lenders have as much responsibility for the debt accumulation as emerging market borrowers: for every questionable borrower there is a questionable lender.

Third, financial markets are inherently volatile. Skittish behaviour of international investors and creditors may have been a major triggering factor in the outbreak of the Asian crisis. Some observers argue that the crisis was no more than a liquidity crisis. In other words, the crisis was mainly caused by the illiquidity of the financial sector where their potential short-term obligations in foreign currency exceeded the amount of foreign currency it could access at short notice. The illiquidity of the financial system was almost entirely rooted in the previous bout of financial liberalisation, which accentuated the maturity mismatch between international assets and liabilities. In addition, capital flows from abroad, caused by an opening of the capital account and a fall in world interest rates, magnified the problem by making available huge amounts of resources that could be intermediated by domestic banks. When this mismatch met the panicking international creditors and their refusal to roll over short-term loans head on, the stage was set for an immediate illiquidity crisis and the resultant bank-runs. As clearly pointed out by Charles Wyplosz, financial repression reduces an important source of economic instability but it is accompanied by serious effectiveness costs that may inhibit growth. This view emphasises the danger of financial liberalisation that is not matched by the necessary regulatory supervision.

Fourth, the original sin hypothesis asserts that currency mismatch reflects structural defect of financial markets of emerging market economies. This is a situation where the countries cannot borrow internationally in their own currencies. In the presence of this incompleteness, financial fragility is unavoidable because all domestic investments will have a currency mismatch. This mismatch exists not because banks and firms lack the prudence to hedge their exposures, but rather because a country whose external liabilities are necessarily denominated in foreign currency is by definition unable to hedge. According to the original sin hypothesis, the solution is not the choice of exchange rate regime, but no exchange rate – dollarisation or its euro equivalent. Once the dollar is adopted for all domestic payments, currency mismatches dissolve, since income streams are denominated

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in the same unit liabilities. However, dollarisation eliminates all scope for an independent national monetary policy and is likely to limit the capacity of the domestic authorities to provide lender of last resort services. In addition, seigniorage accrues to the anchor currency countries. Therefore, dollarisation is most likely unacceptable politically unless a stabilisation device is well prepared.

Given these discussions of the causes of financial instability in emerging market economies, I would like to add a few supporting evidence to his point.

In the 1990s, there were three region-wide crises: the exchange rate mechanism (ERM) crisis of the European monetary system in 1992-93, the Mexican peso crisis of 1994-95, and the East Asian crisis of 1997-98. These three region-wide crises shared a common characteristic in that they gave rise to exchange rate collapse. However, the two emerging market crises have been widely characterised as financial crises of the twenty-first century, clearly distinguished from previous balance of payments crises. The ERM crisis was primarily a currency crisis, and the industrial countries affected by the crisis did not experience a serious banking crisis that disrupted the real economy, except for Sweden and Finland. Great Britain and Italy – countries that were the first to abandon the peg of the sterling and lira to the German market – did not suffer a serious deterioration of macroeconomic indicators. The associated output losses of the ERM crisis were more limited than in the Tequila and Asian crises.

These three region-wide crises have systemic implications for the globally integrated financial markets. In the context of a crisis dominated by capital account fluctuations, capital account liberalisation tends to heighten financial risks and instability. Capital surges and abrupt reversals of capital flows were conspicuous in the three cases of crises. Most of the EMS countries removed capital controls in the years leading up to the crisis. In Mexico, an ambitious structural reform programme and the opening of capital markets invited the ensuing surge in private capital inflows, which allowed Mexico to finance current account deficits of around 7 percent of GDP in 1992-94. In East Asia, even partial capital account liberalisation led to a surge in private sector borrowing with unwarranted exuberance until the bubble burst in 1997.

The core of the East Asian crisis was the failure to appreciate the fatal risks of financial liberalisation and globalisation in the context of weak domestic institutions. Unfortunately, financial liberalisation (both internal and external) has often been synonymous with the accelerated development of short-term instruments. Domestic financial liberalisation, with its removal of limits on bank interest rates, credit expansion, and required reserves, has often resulted in the fast acceleration of bank credit and, conversely, of money aggregates. External liberalisation, in turn, has prompted a large upswing in short-term inter-bank funding from more developed to developing countries. The recent East Asian experience made the case that market freedom requires regulatory vigilance.

Having said this, traditional macroeconomic fundamentals were of secondary significance. If countries had put in place sound institutions to prevent investor herding, contagion, and speculative attacks, they would have been able to thwart the crisis even while going through cyclically unfavourable macroeconomic conditions. Taiwan and Singapore managed the contagion by floating their currencies and insulating their financial markets through a gradual and orderly sequence of capital account opening. China, another one of the less affected economies, was saved by a very restricted capital account during the financial turmoil of its neighbours.

Contrarily, the four crisis-hit countries in East Asia – Indonesia, Korea, Malaysia and Thailand – had structural deficiencies exposed to the vagaries of international capital. Again, market freedom requires vigilance. However, pressured by Western governments and international financial institutions, these four East Asian countries rather involuntarily followed the Washington consensus and liberalised their financial markets prematurely. As a result, they did not consider the possibility that pell-mell liberalisation could invite speculative attacks and financial crises. Singapore and Hong Kong had financially sound and economically healthy fundamentals as well as mature institutions vis-à-vis the above four crisis-affected East Asian countries. However, Hong Kong also became a victim of the crisis because of its firm commitment to the pegged exchange rate system that invited speculative attacks. Hong Kong weathered a series of attacks at the expense of its overall macroeconomic performance.

That the structural frailties of financial systems increased the susceptibility of the East Asian countries to financial crisis is not disputed. However, it is not altogether clear whether those frailties directly caused the crisis. Moreover, the crisis does not provide any evidence suggesting that the Anglo-American market-based system works better than the bank-based system. The East Asian financial weaknesses were by no means inherent in the intermediary-based financial system; they were the consequences of its general lack of transparency and the repressive financial policies which resulted in the inefficient allocation of resources and collusion between large businesses on the one hand and politicians and government policymakers on the other. The moral hazard syndrome stemming from the implicit government guarantee that banks would never fail further compounded the balance sheet problems at the financial institutions.

Since the crisis, East Asian countries have introduced and enforced new rules for accounting and auditing that conform to international standards. Along with these institutional reforms, most East Asian countries have made impressive progress in deregulating and opening financial markets. As a result, financial institutions, markets, and government policies have been evolving to a competitive and market-oriented financial system. These developments are expected to overcome the inflexibility of the existing bank-based financial systems. However, the market-led strategy does not mean that East Asian governments have no important role to play and must blindly move toward becoming minimalist states. The challenge facing East Asia is rather to develop strong governments able both to resist political pressures from domestic financial establishments and to push forward market-led financial development along with necessary institutional reforms. Within such a framework, the East Asian countries have a better chance of converging with advanced financial systems in the future.

As developing countries take time to build up competent institutions, selective globalisation would be preferable. This entails an approach that steers an economy away from excessive short-term capital movements, but maintains trust in free trade and the virtues of foreign direct investment. Given that the road to free markets through financial liberalisation and opening is bumpy enough to deter countries from taking the trip, the safest route seems to be to wait until the necessary institutions are in place. Thus, public policy should be directed at improving institutional infrastructure, legal systems and bureaucracy.

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